IN THE COURT OF APPEAL **Appeal Ref: 2017/0043**
ON APPEAL FROM THE HIGH COURT
CHANCERY DIVISION
COMPANIES COURT
HILDYARD J
[2016] EWHC 2417 (Ch)

IN THE MATTER OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION)

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

B E T W E E N

(1) YORK GLOBAL FINANCE BDH LLC

Appellant

-and-

(1) ANTHONY VICTOR LOMAS
(2) STEVEN ANTHONY PEARSON
(3) PAUL DAVID COPLEY
(4) RUSSELL DOWNS
(5) JULIAN GUY PARR
(THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION))

(6) BURLINGTON LOAN MANAGEMENT LIMITED
(7) CVI GVF (LUX) MASTER SÀRL
(8) HUTCHINSON INVESTORS LLC
(9) WENTWORTH SONS SUB-DEBT SÀRL
(10) GOLDMAN SACHS INTERNATIONAL

Respondents

YORK'S APPELLANT'S SKELETON ARGUMENT
ON THE ISSUE OF
INTEREST ON A POST-ADMINISTRATION CLOSE-OUT SUM
(SUPPLEMENTAL ISSUE 1(A))

Introduction

1. By their application for directions dated 12 June 2014 (the "**Waterfall II Application**"), the Joint Administrators of Lehman Brothers International (Europe) ("**LBIE**") sought directions from the Court as to the correct method of calculating interest ("**Statutory Interest**") under rule 2.88 of the Insolvency Rules 1986 (the "**Rules**") and various related matters.

2. By order of the Court, the Waterfall II Application was divided into three tranches. Tranches A and B were heard by David Richards J (as he then was) and were the subject of two judgments dated 31 July 2015, as well as a further judgment dated 24 August 2016, all of which are also under appeal.

3. Following the main Tranche A hearing, a further supplemental issue ("**Supplemental Issue 1(A)**") was identified, which arose out of the issue determined by paragraph (x) of David Richards J's Order in relation to Tranche A ("**Issue 4**"). David Richards J directed that Supplemental Issue 1(A) be determined by Hildyard J along with the Tranche C issues.

4. Tranche C was subsequently heard by Hildyard J, and it is that Judgment (in particular, the part dealing with Supplemental Issue 1(A) – paras 453-529) which is the subject of the present appeal by York.

5. The decision of Hildyard J in relation to Supplemental Issue 1(A) is related to the decision of David Richards J on Issue 4, and York has appealed against both David Richards J's Order on Issue 4 and Hildyard J's Order on Supplemental Issue 1(A).

6. Both issues concern the construction of the words "*the rate applicable to the debt apart from the administration*" in rule 2.88(9). As David Richards J noted at para.115 of his Tranche B Judgment [2015] EWHC 2270 (Ch), that language "*directs attention to the contractual entitlement of the creditor if there were no administration*".

7. York's primary position is that Hildyard J erred on Supplemental Issue 1(A) and that David Richards J was correct on Issue 4. In the alternative, if Hildyard J was correct on Supplemental Issue 1(A), York submits that David Richards J erred on Issue 4. In either case, York submits that the answer to Issue 4 and Issue 1(A) should be the same and that there is no basis for drawing fine distinctions between the different types of claim which were the subject of those two issues.

Issue 4 and Supplemental Issue 1(A)

8. Issue 4 is:

> *"Whether the words "the rate applicable to the debt apart from the administration" in Rule 2.88(9) of the Rules are apt to include (and, if so, in what circumstances) a foreign judgment rate of interest or other statutory rate."*

9. In his judgment on Tranche A [2015] EWHC 2269 (Ch), David Richards J answered this issue in the negative in circumstances where the creditor had not in fact obtained a relevant foreign judgment as at the date of commencement of the administration (the "**Date of Administration**"), even if the creditor obtained a foreign judgment after the Date of Administration.

10. Supplemental Issue 1(A) is:

> "*Whether, and in what circumstances, the words 'the rate applicable to the debt apart from the administration' in Rule 2.88(9) of the Rules include, in the case of a provable debt that is a close-out sum under a contract, a contractual rate of interest that began to accrue only after the close-out sum became due and payable due to action taken by the creditor after the Date of Administration*".

11. Hildyard J answered this issue in the affirmative and held that the words "*the rate applicable to the debt apart from the administration*" in rule 2.88(9) of the Rules were capable of including a contractual rate of interest applicable to a close-out sum even where the close-out sum had not accrued as at the Date of Administration and where there was therefore no existing contractual entitlement to interest on any close-out sum at that time.

12. York appeals against that finding. In summary, York's position is that:

(1) The words "*the rate applicable to the debt apart from the administration*" in rule 2.88(9) of the Rules do not include either:

i. in the case of a provable debt that is a close-out sum under a contract, a contractual rate of interest that began to accrue only after the close-out sum became due and payable due to action taken by the creditor after the Date of Administration; or

ii. a foreign judgment rate of interest or other analogous statutory rate of interest applicable to a foreign judgment where the creditor had not in

fact obtained a relevant foreign judgment at the Date of Administration.

(2) Alternatively, if Hildyard J was correct in his conclusion that, in the case of a close-out sum, a contractual rate of interest which only became applicable after the Date of Administration was a "*rate applicable to the debt apart from the administration*" then equally a foreign judgment rate of interest (or analogous statutory rate) capable of applying to the relevant debt is a "*rate applicable to the debt apart from the administration*" even where no relevant foreign judgment had in fact been obtained at the Date of Administration.

Legal context: the Tranche A Judgment

13. For the purposes of the Tranche A hearing, the parties were agreed that if a creditor had actually obtained a foreign judgment before the Date of Administration then the interest rate applicable on that foreign judgment would be a rate applicable to the debt apart from administration (Tranche A judgment, para. 172).

14. The question was whether an interest rate which would be applicable to a judgment debt which had not yet been obtained at the Date of Administration was also a rate applicable to the debt apart from the administration. As to this, the Judge's conclusion was that (Tranche A judgment, para. 177):

> *"[t]he words the 'rate applicable to the debt apart from administration'* ***cannot be read as including a hypothetical rate which would be applicable to a debt if the creditor took certain steps****"*
>
> (emphasis added)

15. He stated that the words "*should be given their obvious meaning of the rate* ***in fact applicable*** *to the debt*" (emphasis added).

16. Accordingly, the Judge's conclusion was that the concept of a "*rate applicable to the debt apart from the administration*" required the relevant interest rate to be *in fact* applicable to the debt as at the Date of Administration. A rate which, at the Date of Administration, was only contingently applicable because its application depended on further steps being taken did not suffice for these purposes.

17. It follows from this that the references in paras. 180 and 181 of the judgment to the "*rights*" of the creditors existing as at the Date of Administration were to present and accrued rights of the creditor to receive interest on the relevant debt and not to merely contingent rights to interest i.e. rights the accrual of which was dependent on one or more further steps being taken subsequent to the commencement of the administration. A contingent right to interest, the accrual of which was dependent on some future step being taken, would not constitute a rate of interest "*in fact*" applicable to the debt as at the date of administration.

18. The further point which the Judge made was that there may also be a difference between the debt existing as at the Date of Administration and any subsequent debt to which a right to interest attaches. He noted in this respect (Tranche A judgment, para. 180):

> *"If the creditor does not have a judgment at the date of administration, the debt proved by the creditor is not a judgment subsequently obtained but the debt as at the date of administration. In the case of an unascertained claim, the later judgment quantifies the claim but it is not the judgment debt which is the subject of proof."*

19. The essence of the Judge's conclusion, therefore, was that the words "*the rate applicable to the date apart from the administration*" mean the interest rate which was in fact applicable to the debt as at the Date of Administration. For these purposes, it was necessary to determine whether the creditor had a present right to the relevant interest rate in relation to the debt which existed as at the Date of Administration (and which a creditor later proves for). Further, a right to interest which a creditor would be able to obtain if further steps were taken is not a right to interest which is presently applicable to the debt as at the Date of Administration.

20. Such an interpretation is also consistent with the White Paper that preceded the introduction of rule 2.89, which stated that if "*a higher contractual rate applies to the debt, post-insolvency interest will be chargeable at that rate*". The use of the present tense "applies" strongly suggests that the intention was to cover interest rates that were already accruing on a debt and not to include all rates that might be contingently applicable to a debt if it ceased to be a contingent debt post- administration and so

became an interest bearing debt either contractually, by statute or by virtue of a judgment.

Factual context: ISDA Claims

21. ISDA Claims arise under various different forms of master agreement. However, such claims share common characteristics. In particular, where the relevant transactions had not been closed out as at the Date of Administration, then the claims of the relevant counterparty against LBIE were merely contingent, relating to open derivative transactions, and were not interest bearing.

22. Taking the 1992 ISDA Master Agreement:

    (1) Prior to the occurrence or effective designation of an Early Termination Date, each party was required to make the payments or deliveries specified in the relevant Confirmation (Section 2(a)(i));

    (2) Unless there had been a default in performance, there was no contractual right to interest on such payments or right to compensation for late delivery (which in any case was only applicable to the extent provided for in the Confirmation or elsewhere in the Master Agreement) (Section 2(e));

    (3) Following the occurrence or effective designation of an Early Termination Date, no further payments or deliveries are required to be made under the relevant transactions and there is instead determination of the payment due on Early Termination pursuant to Section 6(e) (Section 6(c)(ii));

    (4) For the purposes of determining such amount ("the Termination Amount"):

        (a) if "*Market Quotation*" is specified, then there is a netting of the Settlement Amount and any amounts which had been already accrued due but which were unpaid ("the Unpaid

Amounts"). For such purposes, the Unpaid Amounts and any Market Quotations are converted into the Termination Currency;

(b) if "*Loss*" is specified, then the relevant sum is the good faith reasonable determination by the non-defaulting party of its total loss in the Termination Currency.

(5) Section 6(d)(ii) then provides:

> "An amount calculated as being due in respect of any Early Termination Date under Section 6(e) will be payable on the day that notice of the amount payable is effective (in the case of an Early Termination Date which is designated or occurs as a result of an Event of Default) and on the way which is two Local Business Days after the day on which notice of the amount payable is effective (in the case of an Early Termination Date which is designated as a result of a Termination Event). Such amount will be paid together with (to the extent permitted under applicable law) interest thereon (before as well as after judgment) in the Termination Currency, from (and including) the relevant Early Termination Date to (but excluding) the date such amount is paid), at the Applicable Rate. Such interest will be calculated on the basis of daily compounding and the actual number of days elapsed."

23. Insofar as material for present purposes, the provisions of the 2002 ISDA Master Agreement are broadly the same as those of the 1992 Master Agreement: see Section 2(a)(i), Section 6(c)(ii), Section 6(d)(ii) and Section 9(h) of the 2002 Master Agreement. Section 6(e) of the 2002 Master Agreement differs from Section 6(e) of the 1992 Master Agreement as to the detail of the calculation of the payments on Early Termination, but that detail is not material for present purposes. Similarly, Section 9(h) of the 2002 Master Agreement differs from Section 2(e) of the 1992 Master Agreement as to entitlement to interest and compensation for late payment and delivery under open transactions, but such differences are not relevant to the rights to interest on a Termination Amount that are the subject of this supplemental issue 1(a).

24. The structure of the 2001 FBF Master Agreement is also essentially the same as the ISDA Master Agreements described above. Thus:

(1) Prior to the Termination Date, each party is required to make the payments or deliveries set out in the relevant Confirmation (Articles 5.1 and 5.2);

(2) Unless there had been a default in performance, there was no contractual right to interest on such payments (Article 9.1) or right to compensation for late delivery (Article 9.2);

(3) Following the occurrence of a Termination Date, there are no longer any obligations to make payment or delivery under the relevant transactions and this is replaced by the obligation to make payment of the Settlement Amount (Article 7.3);

(4) The Settlement Amount is determined in accordance with Article 8.1. This is based on the netting of the Replacement Values for each terminated transaction, such Replacement Values being based on market quotations, and any unpaid amounts ("the Amounts Due") at the Termination Date. For these purposes, any Replacement Values or Amounts Due which are not in the Termination Currency are to be converted into the Termination Currency (Article 8.1.3).

(5) As to the payment of the Settlement Amount, Articles 8.2.4 and 8.2.5 provide:

> "**8.2.4** The Party owing the Settlement Amount (or amount mentioned in Article 8.2.3, as the case may be) shall pay it to the other Party within three Business Days from receipt of the notice mentioned in Article 8.2.1. In the event that the Settlement Amount is due by the Non-Defaulting Party to the Defaulting Party following the occurrence of an Event of Default, the Non-Defaulting Party shall be irrevocably authorised to set-off, within the limits provided for by the law, such amount against any other amount due to it by the Defaulting Party in respect of any dealings between the Parties.
>
> **8.2.5** In the event of delay in payment, interest, calculated in accordance with the provisions of Article 9.1, shall be added to the Settlement Amount (or the amount mentioned in Article 8.2.3, as the case may be)."

25. There are therefore a number of common features of the claims against LBIE which arise under the Master Agreements described above:

(1) Where there had been no Early Termination Date/Termination Date at the Date of Administration, the relevant claims of the counterparty consisted of:

(a) contingent rights to payment and delivery under the open transactions; and

(b) a right to payment of any Unpaid Amounts/Amounts Due in favour of that party (of which there may or may not have been any).

(2) The contingent rights to payment and delivery in (1)(a) did not attract any right to interest or compensation for late delivery under the Master Agreements unless and until a default in performance of the obligations occurred.

(3) Upon occurrence of an Early Termination Date/Termination Date, the claims set out in (1) were replaced by a right to receive payment of the amounts due on termination (i.e. the Termination Amount/the Settlement Amount). This is a different sum, determined in accordance with the contractual machinery in the relevant Master Agreement and after netting out the relevant sums, and which may be denominated in a different currency to that of the original transactions.

(4) The Termination Amount/Settlement Amount is not the same debt as existed before the Date of Administration nor a pure damages claim in respect of that same debt. It is a different contractual entitlement determined after the Date of Administration.

(5) Such amounts then fell due for payment in accordance with Section 6(d)(ii) of the ISDA Master Agreements and Article 8.2.4 of the FBF Master Agreement.

(6) A right to interest on such amounts would accrue if and when there had then been a default in making such payment by the due date.

Tranche C Judgment

26. As noted above, Hildyard J held that the words "*the rate applicable to the debt apart from the administration*" in rule 2.88(9) of the Rules were capable of including a contractual rate of interest applicable to a close-out sum even where the close-out sum had not accrued as at the Date of Administration.

27. In so holding, the Judge considered that the "*central dispute*" was (para.517):

> *"whether or not there is a meaningful distinction for present purposes between, on the one hand, a rate of interest the entitlement to which arises by virtue of a judgment obtained after the date of administration, and, on the other hand, a rate of interest prescribed by contract as applicable to a contractual entitlement contingently or prospectively available to a non-defaulting party but which has not been triggered prior to the date of administration and which cannot be crystallised and/or quantified without further action by that non-defaulting party after that date (for example, by designating an Early Termination Date and/or then taking steps to establish a particular rate of interest)"*

28. Hildyard J held that there was such a distinction (paras 518-521). Accordingly, although David Richards J had held that a foreign judgment rate of interest would not be payable under Rule 2.88(9) where no judgment had been entered as at the Date of Administration, Hildyard J considered that a post close-out rate of interest could be payable even where close-out had not occurred prior to the Date of Administration.

Respect in which Hildyard J erred

29. As explained above, (a) the issue concerns the construction of the words "*the rate applicable to the debt apart from the administration*" in rule 2.88(9) and (b) on the ordinary meaning of the language, "*the rate applicable to the debt*" requires there to be a rate of interest already accruing on the relevant debt as at the Date of Administration.

30. In contrast, in the context of a claim for a close-out sum due under a contract (such as swaps governed by the ISDA Master Agreement), the contingent debt represented by the close-out sum will only ever become a quantified and due and payable termination amount (and so potentially interest-bearing) where a relevant default has occurred which leads to the application of the contractual machinery terminating the rights to payment and/or delivery under the open transaction or transactions and providing for a net close-out sum to be payable from one party to the other. Unless the terms applicable to the transaction provided for automatic early termination in the case of the relevant default, the determination of a net close-out sum will involve service of a notice by the non-defaulting party.

31. In the present case, as at the Date of Administration, the relevant transactions remained open and the outstanding payment and delivery obligations under those transactions remained extant. The termination of those outstanding obligations only occurred subsequent to the Date of Administration and the entitlement to the relevant close-out sums only arose subsequent to the Date of Administration.

32. In this respect, there is no material difference, as a matter of principle or policy, between a creditor taking steps subsequent to the Date of Administration to obtain a judgment based on his contractual rights and taking steps subsequent to the Date of Administration by serving a demand. In both cases, the creditor is invoking and relying on his existing contractual rights in order to obtain greater rights. If an interest rate applicable as a result of obtaining a judgment by invoking those contractual rights is not a rate applicable to the debt apart from the administration, then the same applies to an interest rate applicable as a result of invoking contractual machinery e.g. by serving a demand or notice.

33. Further or alternatively, the "*apart from the administration*" counter-factual requires consideration of the position as if there had been no administration. In particular:

    (1) In circumstances where it is the administration of the debtor company which is the relevant default for the purposes of enabling the application of the contractual machinery providing for the establishment of a close-out sum this requires consideration of the position as if there had been no such default.

(2) In the case of LBIE, ignoring the effect of its administration, there is no basis for assuming that there was any other default as at the Date of Administration which would have enabled the application of the contractual machinery terminating the payment and delivery obligations under the outstanding transactions and providing for a net close-out sum to fall due from one party to the other.

(3) Accordingly, for this reason the contractual rate of interest which applies to a close-out sum once it has fallen due cannot be said to be a "*rate applicable to the debt apart from the administration*". There is no basis for considering that, absent the administration, there would have been any default and thus any entitlement to determine a close-out sum or any right to contractual interest on any such sum.

34. Accordingly, Hildyard J should have concluded that, as at the Date of Administration, the relevant creditors had no accrued entitlement to any close-out sums and no accrued entitlement to any interest on such sums, and that the contractual right to interest on such close-out sums was not therefore a rate applicable as at the Date of Administration.

Alternative Submission: Issue 4 was wrongly decided

35. The above submissions proceed on the basis (as is York's primary position) that Issue 4 was correctly decided by David Richards J.

36. However, if contrary to the above, a contractual entitlement to interest on a close-out sum which only arose after the Date of Administration is a "*rate applicable to the debt apart from the administration*" then equally a foreign judgment rate of interest (or analogous statutory rate) capable of applying to the relevant debt is a "*rate applicable to the debt apart from the administration*" even where no relevant foreign judgment had in fact been obtained at the Date of Administration.

37. There is no basis for distinguishing for these purposes between the type of claim to a close-out sum which was the subject of Supplemental Issue 1(a) and a foreign judgment which was the subject of Issue 4:

(1) In both cases, the creditor has a contingent debt as at the Date of Administration that can only become interest-bearing if some action is taken by the creditor on or after the Date of Administration.

(2) As a matter of policy, there is no basis or reason for drawing any distinction between the two scenarios.

(3) Moreover, as a matter of legislative intent, it is not likely that it was intended that an insolvency officeholder would have to make fine distinctions as to whether the "*source*" of such a right to interest can be said to arise pre- or post- the Date of Administration. It is much more likely that the draftsman of the Rules intended that a relatively simple determination is to be made that either: (1) excludes all interest rates not already accruing on the relevant debt prior to the Date of Administration or (2) includes all interest rates capable of applying to the relevant debt on or after the Date of Administration.

38. Accordingly, York's alternative submission is that it was Issue 4 which was wrongly decided by David Richards J[1].

Conclusion

39. The Court of Appeal is therefore invited to allow York's appeal, and to declare that the words "*the rate applicable to the debt apart from the administration*" in Rule 2.88(9) of the Rules do not include, in the case of a provable debt that is a close-out sum under a contract, a contractual rate of interest that began to accrue only after the close-out sum became due and payable due to action taken by the creditor after the date of the commencement of LBIE's administration.

Tom Smith QC

Robert Amey

South Square
Gray's Inn
London, WC1R 5HP
31 January 2017

[1] For these purposes only, York also relies on the submissions made by the SCG on Issue 4.